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National Committee On
PUBLIC EMPLOYEE PENSION SYSTEMS (PEPS)

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JOINT STATEMENT OF JOHN W. MACY, JR.

AND HASTINGS KEITH, CO-CHAIRMEN,

NATIONAL COMMITTEE ON PUBLIC EMPLOYEE PENSION SYSTEMS

BEFORE THE

HOUSE COMMITTEE ON POST OFFICE AND CIVIL SERVICE

APRIL 30, 1985

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Mr. Chairman and Members of the Committee:

We appreciate very much your invitation to our Committee to present views regarding the characteristics of the new retirement system for Federal employees entering service subsequent to December 31, 1983. For the record, our respective residences are 5047 Glenbrook Terrace, N. W., District of Columbia (Keith) and 1127 Langley Lane in McLean, Virginia (Macy). We are appearing in our capacities as Co-Chairmen of the National Committee on Public Employee Pension Systems (PEPS).

The membership of the Committee appears on our letterhead; practically all the members are former elected officials or employees of the legislative and executive branches in national, state and local governments, and most are receiving pensions from one or more public retirement systems. PEPS is organized as a non-profit corporation and receives its financial support from contributions and grants from its members and private foundations and businesses. The Committee first came into being because of shared concerns about some of the equity and affordability aspects of public employee pension systems, especially the federal civil service and military retirement systems.

The Committee has conducted some original research, but the bases for its considered views have relied extensively on data collected by others, including principally the research and evaluation arms of the Congress (GAO, CRS, CBO), the Federal Executive Branch (OMB, OPM, Labor and Census), previous study commissions, and private and non-profit organizations such as the Employee Benefit Research Institute (EBRI), the Brookings Institution, and the National Bureau of Economic Research.

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Drawing upon the foregoing resources, early this year the Committee adopted a list of essential components of a supplemental retirement plan for post-1983 hires within the context of a defined benefit structure; the list is appended hereto. Coincidentally, its general thrust conforms rather closely to the conclusions of the Brookings research team which last year addressed overall issues associated with growing budget deficits. Regarding federal retirement systems, the findings, as reported by Dr. Alice M. Rivlin in the Brookings Review, Summer, 1984 were:

> Both the civil service and military retirement systems should be changed to bring them more in line with private-sector pension plans. For future retirees, initial benefits should be reduced somewhat and full benefits should be available only to those sixty-two years of age or older. Benefits for current and future retirees should be only partially indexed for inflation.

Our statement today concentrates upon the five specific issues set forth in your letter of invitation.

Appropriate Cost of the New System

The Committee believes that the new system should be substantially less expensive than the existing system, while at the same time providing improved scope of coverage of federal workers and lessening or eliminating several inequities found in the existing system. We believe that the cost of the new system should be comparable to the better plans found in the private sector. The two major cost factors identified in the Brookings study--retirement age and cost-of-living adjustments--should be brought more into line with private sector practice.

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The 1984 Wyatt survey of the "Top 50" of the Fortune 500 companies showed that in most cases, those retiring at age 55 received immediate benefits that provided replacement ratios of 25 to 35 percent of final pay with 30 years of service, and with full benefits including Social Security not obtainable before age 62. Regarding cost-of-living adjustments, the same survey found that benefit increases on the average replaced only one third of the erosion in purchasing power as measured by the Consumer Price Index for those individuals who had been retired from 6 to 10 years.

We propose that the normal retirement age for the new system be 65 initially, with future increases as mandated by the Social Security Amendments of 1983, and with early retirement subject to a 3 percent reduction for each year age 62 to 65 and a 6 percent for each year age 55 to 61. In contrast to current high rates, this represents a low rate of early retirement subsidization (full actuarial reduction at 55 would be 60%, in comparison to our proposed 51%--7x6% plus 3x3%).

Regarding COLAs, we propose no COLA for the supplemental benefit, in light of the current full indexation of the Social Security portion of the prospective benefit. For present retirees, we have for several years urged a capping of civil service and military COLAs at the level of maximum Social Security benefits (currently approaching $10,000). This approach is much more equitable and adequate to those on lower retirement incomes than by simply adopting a COLA freeze or a formula such as the "CPI minus two."

As a final point, we concur in recommendations made by other groups for

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returning final average pay to a high-five definition instead of a high-three.

The "Social Security Tilt"

The weighting of Social Security benefits toward lower earnings levels raises the question as to whether a relatively larger supplemental benefit should be provided to higher paid workers as is done in some private sector plans. In a study completed by our Committee in early 1984, the alternative of an "income-differentiated replacement ratio" to offset this tilt was explored, using a concept of setting the replacement ratio percentage of pre-retirement final pay at a level sufficient to replace pre-retirement consumption needs--i.e. consumption maintenance as opposed to income maintenance.

Applying a 30-year service requirement for full benefits at age 65, the required factor multiplier in the benefit formula for a supplemental pension plan on top of Social Security, for final pay levels of $10, $25, $50, and $75 thousand, would be .48, .90, 1.16, and .80, respectively. It was our conclusion that such a structure would be hard to understand and defend and that a factor multiplier of 1.0 would be substantially equitable and adequate for all income levels except the lowest, where the tilt effect would remain most pronounced.

Again, our analysis and similar ones that preceded ours show that in order to maintain pre-retirement purchasing power upon retirement, a higher proportion of pre-retirement income needs to be replaced for low salaried employees than for high salaried employees.

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Employee Contributions

Given the current level of required employee contribution to Social Security, and with the prospect of higher future payroll tax rates, we believe that a supplemental defined benefit plan should be financed entirely by agency contributions. For employees who leave federal service and cannot immediately draw pensions, this would negate the issue of having to decide whether or not to leave their past contributions in the system--as is currently the case for employees in the existing system. Additionally, employees who leave federal service prior to vesting eligibility will have established portable credits because of Social Security coverage.

Method and Level of Funding

The overriding need here is for full cost disclosure in such terms as to minimize the continuing argument about meaning and accuracy of figures. To this end we propose that:

> (1) each agency include in its budget the annual estimated actuarial cost as a percent of payroll, exclusive of any employee contributions that might be mandated for the supplemental system; (2) the consolidated balance sheet of the U. S. Government be required to reflect the accrued liability for both the new and the old systems, with annual increases in such accrued pension liabilities to be included as costs in the President's unified budget; and (3) full funding of the entry-age normal cost through agency inclusion in annual budgets pursuant to (1) above.

Various methods for handling the amortization of unfunded liabilities comprise difficult and controversial problems and require further study.

To repeat, all projected pension costs should be faced both initially and

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continuously thereafter. This includes any losses in federal revenues in the event that a thrift plan is included as a part of the new system. (Our Committee does not recommend such inclusion.)

Vesting

We recommend full vesting of all credited benefits upon the achievement of five years of service.

Additional Issues

In addition to the foregoing, the Committee has recommendations regarding three other aspects of the new retirement system:

> (1) transfer of certain present employees to the new system; (2) recovery from certain retirees of earlier benefits arising from the unwarranted one-percent "kicker"; and (3) provision of disability and survivorship benefits under the new system, both expanding and contracting present coverages.

In order to avoid too wide a chasm between employees in the old and the new systems and to lower future costs, those employees under age 45 as of the effective date of enactment should mandatorily be brought into the new system, with eventual benefits pro-rated between the old and new formulas based on the years of service under the respective systems. (e.g. assuming factor multipliers and retirement ages suggested above, and assuming initial entry into federal service at age 25, an employee at age 44 with 19 years of service coming into the new system would reach a replacement ratio of 45.25% at age 55, plus Social Security, both fully collectible at age 65; a 35-year-old empoyee would reach a replacement ratio of 36.25% at age 55--10 years under the old system for 16.25% and 20 years under the new system for 20%.)

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Retirees who benefited from the compounding effects of the one per cent "kicker" which was in effect from 1969 to 1976 (and costing an estimated $30 to $40 billion over the life expectancies of the retirees and their survivors) should receive no COLAs until the CPI rise is such that past costs attributed to the kicker have been recovered. In addition to over-compensating retirees, the kicker substantially and unfairly widened the gap between retirees and active duty employees. To the extent feasible, the pre-kicker relationship should be restored.

Survivorship coverage for spouses should be automatic rather than elective; criteria for disability benefit eligibility should be the same as those for Social Security Disability Insurance; and a percentage cap, at a level determined by Congress, should be placed on total disability payments to an individual from private pension plans, Social Security and other employer- or government-sponsored plans--the cap being set at a percentage of final annual pay prior to disability.

Thank you, Mr. Chairman, and Members of the Committee. This concludes our statement.

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Essential Components of a Supplemental Retirement Plan for Federal Employees Covered Under the Social Security Amendments of 1983, as Proposed by The National Committee on Public Employee Pension Systems (PEPS)

I. Retirement Age:

A. Normal Retirement Age will be the age when unreduced Social Security Old Age Insurance benefits become available (currently age 65 with future increases mandated by Social Security Reform Act of 1983).

B. Early Retirement:

1. Age 62-Normal Retirement Age: Employees with 5 or more years of service will incur a 3 percent reduction in benefit amount for each year prior to Normal Retirement Age that retirement commences.
2. Age 55-61: Employees with 5 or more years of service will incur 6 percent reduction in benefit amount for each year prior to age 62 that retirement commences, in addition to reductions listed in I.B.1.[1]

II. Factor Multiplier:

A. The factor multiplier will be 1.0% times years of service, up to 30 years of service, and

B. 0.5% times years of service, for service beyond 30 years.

III. Final Average Pay:

Final average pay will be defined as average of highest five years' salary.

IV. Vesting:

Full vesting of all credited benefits after 5 years of service.

V. Employee Contributions:

New employees will make no contribution, except to Social Security.

VI. Financing of Supplemental Plan:

All contributions will be made by employing agency, with each agency to include in its budget the annual estimated actuarial cost.

[1] The reduction in benefits for an individual retiring at age 55 would be 51% (7 times 6 percent plus 3 times 3 percent) with a full actuarial reduction being about 60%, these suggested reductions provide some subsidization of early retirement, thereby allowing some desirable flexibility to both agencies and employees.

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VII. Cost of Living Adjustments (COLAs)

Inasmuch as inflation protection will be borne by Social Security portion of retirement benefits, no automatic COLAs are provided in the supplemental portion of the plan.

VIII. Survivorship Benefits:

A. Rather than an elective system as in the present plan, supplemental plan will provide automatic coverage for the surviving spouse[2] at no cost to the employee.
B. Eligibility will be limited to the surviving spouse of a retired employee, or spouse of an employee qualified for retirement but still actively employed.
C. The automatic survivorship benefit will equal 50 percent of supplemental benefit; if death occurs before normal retirement age, benefit will be 50 percent of benefit computed as for early retirement in I.B.1. and 2., above.
D. Employee will be allowed to elect other survivor options on an actuarially equivalent basis.

IX. Disability Benefits:

A. Criteria for eligibility will be the same as those for Social Security Disability Insurance.
B. The disability benefit will be equal to the lesser of the accrued benefit under supplemental plan for credited service to age 65. The benefit will commence after six months of disability.
C. In no event shall total disability payments from Social Security and employer- or government-sponsored plans, including sick leave, exceed a specified percentage[3] of final annual pay prior to disability.
D. The above assumes a full or partial continuation of salary for up to six months under an accident or sickness plan.

X. Funding:

A. The consolidated balance sheet of the U.S. Government will be required to reflect the accrued liability for all federal pension programs. Annual increases in the accrued pension liabilities and current employer payments to the CSRS Trust Fund will be included as costs (budget authority or obligations) in the President's unified budget.
B. The normal cost will be fully funded. Various methods for handling the amoritization of the unfunded liability require further study.

[2] "Surviving spouse(s)" would need to be defined by the Congress.

[3] As determined by the Congress (e.g., 60, 80, etc. percent).

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XI. Coverage of Present (pre-1984) Employees and Retirees:

A. Those employees under age 45 as of January 1, 1986 will be brought into the new system, with a pro-ration applicable to service and consequent contributions to existing CSRS. The remainder of Civil Service employees will be provided a one-time election to join the Social Security system and to be covered by the new CSRS program.

B. For those employees not covered by the supplemental system, COLAs will be based on 100% of the CPI applied to benefits not in excess of the primary Social Security benefit payable to a person who has always had maximum covered earnings and who attains normal retirement age (currently age 65) in the current year. Current employees' initial retirement COLA will not be payable until attainment of age 6~~2~~5

C. Retirees receiving pensions in excess of the primary Social Security benefit as defined in (b) above and who benefited from the compounding effects of the "1% COLA Kicker" (in effect from 1969 to 1976) will receive no COLAs until the CPI undergoes a percentage increase equal to that of the affected cohort's COLA percentage increase.

XII. Thrift/Savings Plans:

The foregoing plan components provide adequate retirement income for the federal retiree. Consequently, the Committee believes a government-financed supplemental thrift/savings plan is not required.

NOTE: The foregoing set of components do not purport to deal with all of the issues involved in the creation of a new retirement system connected to Social Security (e.g., early retirement due to reductions in force (RIFs) and severance pay provisions related thereto; the counting of military service in other pension programs; foreign service retirement; retirement from hazardous employment - public safety, air traffic control, etc.)

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